No. 96-842 (8)

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

vs.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF *AMICI CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AND LAW PROFESSORS IN SUPPORT OF PETITIONER

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CONSENT OF PARTIES

Petitioner and respondent have consented to the filing of this brief, *amici curiae*.[1]

INTEREST OF *AMICI*

This brief, *amici curiae*, is submitted on behalf of the North American Securities Administrators Association, Inc. ("NASAA") and a group of law professors at universities in the United States.[2]

NASAA is the forum in which the securities regulators of the fifty states, the District of Columbia, Puerto Rico, the Canadian provinces and territories and the Republic of Mexico ("Members") work in conjunction with each other and with federal and international securities regulators to protect investors and to promote fair, open and honest capital markets. State, provincial and territorial securities commissioners are charged with regulating the securities markets and combating securities frauds in their respective jurisdictions. NASAA is the collective voice for its Members in advancing those interests. The dual system of federal and state securities regulation is recognized by Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r (1994), and by Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb (1994), which preserves enforcement of state antifraud provisions. Congress recently preserved that role in the National Securities Markets Improvement Act of

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1. Their consents have been filed with the clerk of this Court. This brief was authored by the amici and counsel listed on the front cover hereof, and was not authored in whole or in part by counsel for a party. No one other than the amici and their counsel made any monetary contribution to the preparation or submission of this brief.

2. The law professors are listed in an appendix to this brief.

1996. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (to be codified in various Sections of 15 U.S.C.).

NASAA has a dual interest in the present case. First, the antifraud provisions in the Uniform Securities Act of 1956 are modeled after the federal provisions central to this case. NASAA has a great interest in the collateral effect of judicial interpretations of federal provisions on state statutes. Uniform interpretations provide important guidance to market participants concerning the parameters of acceptable behavior in the marketplace. Moreover, state courts, having correspondingly fewer cases construing state acts, often look to applicable federal precedent when deciding cases, particularly from this Court. Second, as an association of state securities regulators, NASAA has an interest in the effected enforcement of federal and state securities laws to police our markets and maintain investor confidence. NASAA wishes to express its own views herein as the Court revisits the misappropriation theory under Section 10(b) of the Exchange Act and Rule 10b-5.

As teachers and scholars of corporate law and securities regulation, the law professor amici are interested in the proper interpretation and application of the federal securities laws. The law professor amici have received no compensation or promise of compensation for submitting this brief. They join this brief solely because they believe that the Eighth Circuit improperly construed the federal securities laws and that affirmance of its decision would impede the proper functioning of those laws.

SUMMARY OF ARGUMENT

1. Respondent violated Section 10(b) of the Exchange Act and Rule 10b-5 when he used material nonpublic information he obtained through a relationship of trust and confidence to trade securities in the public securities markets in breach of his fiduciary duties to his firm and a client of his firm with an interest

in such securities. The SEC is authorized to prohibit such trading by Section 10(b), and has done so with Rule 10b-5. Prohibition of such trading serves important federal interests and protects fiduciary relationships while at the same time assuring adequate incentives for securities research and information verification.

This Court should adopt the theory previously adopted in the Second, Seventh and Ninth Circuits, but rejected below, that a person who has been entrusted with material nonpublic information and assumed a duty not to use it for personal profit violates Section 10(b) and Rule 10b-5 if he subsequently uses that information to trade securities in the public market in breach of that duty. Respondent's trading consummated a deception, and that deception was in connection with the purchase or sale of securities, particularly because his firm's client was interested in purchasing securities.

Independently of the theory adopted by most courts that a person who trades securities on the basis of material nonpublic information in breach of fiduciary duties violates Section 10(b) and Rule 10b-5, this Court should hold that a person who trades on the basis of misappropriated material nonpublic information violates Section 10(b) and Rule 10b-5. This theory of liability responds to the same kind of deception of marketplace traders through silence that is present when corporate insiders illegally trade on inside information, and because the victims of this fraudulent concealment are themselves trading contemporaneously with the wrongdoer, the deception is clearly "in connection with" the purchase or sale of securities.

2. Rule 14e-3 is a valid and enforceable rule. Section 14(e) of the Exchange Act authorized the SEC to promulgate Rule 14e-3. Rule 14e-3 appropriately and lawfully responds to the special problems posed by the possibility that those privy to information about tender offers may abuse that information by trading securities.

3. The validity of the misappropriation theory under Section 10(b) and Rule 10b-5 and of Rule 14e-3 has been confirmed by statute. Amendments to the Exchange Act enacted in 1984 and 1988 established that it is a violation of Section 10(b) and Rule 10b-5 for a person who has learned material nonpublic information in the course of a relationship of trust and confidence to trade securities on the basis of such information in violation of duties assumed in that relationship. The 1988 legislation also spoke directly to the SEC's rulemaking authority and established that the misappropriation theory and Rule 14e-3 are within the SEC's rulemaking power.

ARGUMENT

I.

RESPONDENT VIOLATED SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5 WHEN HE USED MATERIAL NONPUBLIC INFORMATION TO TRADE SECURITIES FOR PERSONAL GAIN IN THE PUBLIC SECURITIES MARKETS IN BREACH OF HIS FIDUCIARY DUTIES TO THE SOURCES OF THAT INFORMATION, HIS FIRM AND A CLIENT OF HIS FIRM WITH A KNOWN INTEREST IN SUCH SECURITIES.

A. The misappropriation theory appropriately balances the need to protect confidential corporate information with the need for analysts and investors to conduct and have access to securities research and information.

When respondent used material nonpublic information obtained in the course of a special relationship of trust and confidence to trade securities for his personal benefit in breach of his fiduciary duties, he injured both the corporation whose secrets and plans had been entrusted to him and his law firm,

whose confidence he betrayed, and he undermined the efficiency and integrity of the securities markets. The federal securities laws protect against such injuries by making it unlawful to trade securities on the basis of informational advantages that public investors cannot lawfully overcome.[3] At the same time, the federal securities laws recognize the importance of the legitimate discovery and use of information, and accordingly do not require that everyone who possesses material nonpublic information disclose it. Instead, as this Court recognized in *Dirks v. SEC*, "in an inside-trading case this fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.' " 463 U.S. 646, 654 (1983) (*quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

The misappropriation theory appropriately balances the protection of confidences with the production and dissemination of information. It forbids conversion, by trading, of information belonging to another in violation of a pre-existing legal, contractual or fiduciary duty. Such misuse of information is the very opposite of legitimate information production, and indeed the risk of misappropriation reduces the incentive to produce information in the first place. By keying the prohibition of trading to the existence and breach of a duty of confidentiality, the misappropriation theory fully protects legitimate research and analysis, while also protecting the creators of information

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3. *See* Donald C. Langevoort, Insider Trading: Regulation, Enforcement & Prevention (1996); 7-8 Louis Loss & Joel Seligman, Securities Regulation 3404-3937 (3d ed. 1991 & Supp.); William K.S. Wang & Marc I. Steinberg, Insider Trading (1996); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322 (1979); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385 (1990) (suggesting that Section 10(b) gives the SEC extremely broad rulemaking power).

and the efficiency and integrity of the securities markets. It is noteworthy that policy makers trying to balance the interests of those information owners who legitimately expect their own officers, directors and professional service providers to refrain from trading on such information with the public interest in vigorous securities research and analysis, consistently conclude that the misappropriation theory strikes the correct balance.[4] The misappropriation theory could hardly work to chill legitimate information production in any event, inasmuch as the federal mail and wire fraud statutes independently prohibit most misappropriation. *See Carpenter v. United States*, 484 U.S. 19 (1987). The availability of these statutes should not preclude application of the securities laws, however, since the securities laws may be enforced by the SEC in civil and administrative actions and by contemporaneous public traders in civil actions under Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (1994).

Respondent's trading endangered his law firm's client, Grand Metropolitan PLC, and injured the public interest in efficient securities markets. It is well established that trading in advance of a tender offer on the basis of confidential material information obtained from the tender offeror may seriously injure the offeror because it can alert the target, legally embarrass the offeror, and increase the acquisition price to the offeror to the extent such trading can be decoded by participants in the market as a sign of an impending tender offer. *See United States v. Newman*, 664 F.2d 12, 17-18 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); W. Wang & M. Steinberg, *supra*, at 496. Both respondent's law firm and its client had an acute interest in keeping their plans secret and assuring that respondent did not

4. *See* D. Langevoort, *supra*, ch. 13 (discussing various legislative proposals); *see also* European Economic Community Council Directive on Insider Dealing, *reprinted in* O.J. Econ. Comm. L334/30 (Nov. 18, 1989).

alert the market to the impending tender offer by his trading.[5] Thus, it was by his act of trading that respondent endangered those to whom he owed a duty of confidence, and it was his trading that constituted his breach of duty. Absent trading by respondent or a tippee, respondent's conduct could not have injured Grand Metropolitan; therefore, respondent's trading was not separate from his breach of duty, but was the direct cause and consummation of that breach.

The fact that respondent's trading endangered Grand Metropolitan's own trading, distinguishes this case from others in which the victim of the breach of duty was not itself a market participant. For example, in *Carpenter v. United States*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987), the *Wall Street Journal* did not have an interest in the securities traded by its faithless agent and his tippees, *see* 791 F.2d at 1028-29, although it did have an interest in maintaining its reputation for honest reporting. Grand Metropolitan's interest in the traded securities also distinguishes *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), whose analysis the Eighth Circuit purported to adopt "in its entirety as our own." *See* 92 F.3d at 620. Although the Fourth Circuit refused to apply the misappropriation theory in *Bryan* where the victim of the misappropriation (a state agency) was not a market participant, it suggested that a very different situation would have been presented had the owner of the information been trading. According to the Fourth Circuit, Section 10(b) "reaches only deception of persons *with some*

5. *See Dirks v. SEC*, 463 U.S. at 655 n.14 ("For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty."); *see also United States v. Chestman*, 947 F.2d 551, 576-78 (2d Cir. 1991) (*en banc*) (Winter, J., concurring in part and dissenting in part) (emphasizing the harm to confidentiality and business property caused by those who breach duties of confidence by trading on material nonpublic information), *cert. denied*, 503 U.S. 1004 (1992).

connection to, or some interest or stake in, an actual or proposed purchase or sale of securities." 58 F.3d at 950 (emphasis added). Respondent's trading did directly injure and deceive his firm and its client, which had a very clear "connection to" and "interest or stake in" a proposed purchase of securities.

By trading for personal gain on the basis of confidential information that he had no right to use, respondent also injured the efficiency and integrity of our securities markets — a concern that is now more vital than ever as securities trading becomes globalized. Trading in organized securities markets is usually effected through specialized intermediaries (*e.g.*, market makers in dealer markets or specialists on the exchanges), who determine a bid-ask spread at which they trade with public customers. The width of the spread between the prices at which intermediaries will buy or sell (the bid-ask spread) is essentially a measure of the efficiency of the market for a security. While dealers and specialists are the initial victims of those who trade on misappropriated material nonpublic information, they pass this injury along to public customers through a widened bid-ask spread. To the extent it is foreseeable that people will trade with misappropriated material nonpublic information, intermediaries must protect themselves in advance by widening the bid-ask spread. Thus trading by those who misappropriate material nonpublic information for personal profit necessarily injures all public customers by decreasing the price at which they can sell to intermediaries (the bid) and increasing the price at which they can buy from intermediaries (the ask). Indeed, customers trading other securities will also be injured, because dealers cannot anticipate which securities will be traded by those in possession of material nonpublic information and will consequently widen the bid-ask spread for all securities that may be the subject of such information.[6] Trading on misappropriated

6. *See* Lawrence R. Glosten, *Insider Trading, Liquidity, and the Role of the Monopolist Specialist*, 62 J. Bus. 211 (1989).

information, like insider trading, decreases market efficiency and thus adversely affects all who trade in the public securities markets.

B. The misappropriation theory as articulated in the Second, Seventh and Ninth Circuits but rejected below is a valid interpretation of Rule 10b-5, consistent with Section 10(b).

Respondent violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 when he used material nonpublic information to trade securities in the public securities markets in breach of his fiduciary duties to his firm and a client of his firm with an interest in such securities. Section 10(b) makes it unlawful for *any person* to use or employ, in connection the purchase or sale of *any security*, any manipulative or deceptive device or contrivance in contravention of such rules as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 10b-5 forbids any person to engage in any act or practice which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of securities. Three courts of appeal and several district courts have held that Section 10(b) and Rule 10b-5 reach those who breach a duty of trust and confidence by misappropriating material nonpublic information through the act of trading.[7] These courts grounded their decisions

7. *See United States v. Cherif*, 943 F.2d 692 (7th Cir. 1991), *cert. denied*, 503 U.S. 961 (1992); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); *see also United States v. Libera*, 989 F.2d 596 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *SEC v. Lenfest*, 1996 U.S. Dist. LEXIS 18961 (E.D. Pa. Dec. 23, 1996); *SEC v. Willis*, 787 F. Supp. 58 (S.D.N.Y. 1992); *SEC v. Singer*, 786 F. Supp. 1158 (S.D.N.Y. 1992); *cf. United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (*en banc*) (endorsing doctrine but finding no duty in family relationship), *cert. denied*, 503 U.S. 1004 (1992); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985).

in the language and structure of the Exchange Act, and amici agree with their analysis. This Court should also hold that such trading is within the proscription of the Exchange Act.

Respondent employed a deceptive device and contrivance in contravention of Rule 10b-5, and thereby violated Section 10(b), when he used confidential material nonpublic information obtained from his firm's client to buy securities in the public market. The jury apparently found that respondent falsely represented himself as a faithful agent, pretended to perform his duty to safeguard information he received from the firm, made "secret profits" from the confidential information entrusted to him or failed to disclose his breach of his duty of confidentiality. *See Carpenter v. United States*, 484 U.S. 19, 27-28 (1987); *Dirks v. SEC*, 463 U.S. 646, 654, 655 n.14 (1983). This pattern of deception is within the scope of Section 10(b) and Rule 10b-5 and was "in connection with" the purchase or sale of a security. Respondent breached his fiduciary duties as a partner of his firm and to its client when and only when he purchased securities. His firm's client expected strict confidentially regarding its plans precisely because it was about to make substantial purchases of its own. Indeed, the material nonpublic information that respondent misused was that his firm's client was about to purchase securities.

C. This Court should recognize a duty under Section 10(b) not to trade on the basis of misappropriated material nonpublic information.

For the reasons stated above, the misappropriation theory as articulated by a majority of the courts of appeals that have considered the issue — the "fraud on the source" theory — is well grounded in the Exchange Act. But even if criticism of that theory were persuasive, this Court can and should hold that a person who trades securities on the basis of misappropriated

material nonpublic information violates Section 10(b) and Rule 10b-5, and affirm respondent's conviction.[8]

When the *Chiarella* case came before this Court, the United States made two separate arguments that Chiarella's conviction should be upheld because he had misappropriated information from his employer (a financial printer) and his employer's customers (bidders in various takeover battles). Because the Court found that neither theory was properly presented to the jury during the criminal trial, it expressly refused to rule on them and thus reserved both for future consideration. 445 U.S. at 236-37. One theory was that this misappropriation operated as a fraud on the printer and its customers. This theory, which was referred to in Justice Stevens' concurring opinion, *id.* at 238, later evolved into the "fraud on the source" standard now accepted in the Second, Seventh and Ninth Circuits.

The government's other misappropriation theory was different. It argued that the misappropriation of information in violation of a duty of trust and confidence should give rise to a duty to disclose this information to other marketplace traders. This theory, again specifically reserved by this Court because of the failure of the jury instructions to refer to it, received a strong endorsement from Chief Justice Burger in his dissenting opinion in *Chiarella*. *Id.* at 239-43. The Chief Justice took note of common law history that has long used the law of fraud to prevent the exploitation of stolen information.[9]

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8. Because the jury found that respondent misappropriated information and because the difference between the two misappropriation theories is a matter of characterizing the legal effect of a misappropriation, there is no unfairness to respondent in sustaining his conviction on the basis of a disclosure obligation even if the "fraud on the source" theory is rejected.

9. Chief Justice Burger cited the classic article by the late Dean Page

(Cont'd)

Chief Justice Burger's disclosure-based misappropriation theory of liability is a sound and sensible application of Section 10(b) and Rule 10b-5, and it satisfies the statutory requirements of deception and a connection to the purchase or sale of securities. Violation of a duty to disclose that is imposed on those who steal information involves exactly the same kind of deception of other marketplace traders through silence as the now well-established duty to disclose imposed on corporate insiders and tippees after *Chiarella* and *Dirks*. *See Dirks*, 463 U.S. at 653 n.10 ("[T]he *Cady, Roberts* Commission recognized, and we agree, that '[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.' ") (*quoting Cady, Roberts*, 40 S.E.C. 907, 912 n.15 (1961)); *id.* at 654. And because the victims of this fraudulent concealment are the buyers or sellers of securities trading contemporaneously with the misappropriator, the "in connection with" requirement of Section 10(b) is amply satisfied. Thus, reframing the misappropriation theory in terms of a disclosure duty completely deflates the two principal objections to it made by the court below.

As noted above, *Chiarella* expressly leaves open the possibility of this alternative duty of disclosure to the marketplace. Although dicta in *Dirks* might arguably be read to foreclose this avenue, the Court in that case explained that Rule

(Cont'd)
Keeton, *Fraud-Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1, 25-26 (1936), in which the author summarizes his view of the law that "Any time information is acquired by means of an illegal act it would seem that there should be a duty to disclose that information." *See, e.g., Phillips v. Homfray*, L.R. 6 Ch. App. 770, 779-80 (1871). The common law has evolved to a point where a duty to disclose is routinely imposed in cases involving the unfair exploitation of superior knowledge or expertise. *See* Deborah A. DeMott, *Do You Have a Right to Remain Silent? Duties of Disclosure in Business Transactions*, 19 Del. J. Corp. L. 65 (1994).

10b-5 bars so-called temporary insiders from tipping or trading on the basis of material nonpublic information because "they have entered into a special confidential relationship with the source of that information and are given access to information solely for purposes of that relationship." 463 U.S. at 655 n.14. The Court also held that to determine whether an insider's disclosure of material nonpublic information "itself 'deceive[s], manipulate[s] or defraud[s]' shareholders, the initial inquiry" focuses on "whether the insider receives a direct or indirect personal benefit from the disclosure," *id.* at 663, not on communications between the insider and the investors with whom the tippee(s) trade. Moreover, in absolving Dirks from liability, the Court took pains to point out that Dirks did not "misappropriate or illegally obtain the information about Equity Funding." *Id.* at 665. The Court's holding, therefore, does not foreclose a viable alternative duty of disclosure when there has been a misappropriation. In *Bateman Eichler Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), this Court interpreted *Dirks* to leave room for a duty based on misappropriation, saying that "[w]e have noted that a tippee may be liable if he otherwise 'misappropriate[s] or illegally obtain[s] the information.' " *Id.* at 313 n.22 (*quoting Dirks*, 463 U.S. at 665).

For the reasons stated in Part I(A) of this brief, a duty to disclose based on misappropriation is a sound mechanism for promoting the efficiency of the securities markets and avoiding the tangible harm to market institutions that flows from the exploitation of stolen information. Unlike the "parity of information" theories rejected in *Chiarella* and *Dirks*, such a disclosure duty would not threaten legitimate research or analysis, or innocent investor behavior. Just as under the fiduciary obligation theory articulated in *Chiarella* and *Dirks*, disclosure is compelled only when the information is the property of another and the trading violates a pre-existing legal duty of loyalty, so that the trader cannot claim to deserve the trading profits from information that the victim could not lawfully obtain.

Recognizing a misappropriation-based duty to disclose squares well, then, with the underlying purpose and philosophy of Section 10(b) and Rule 10b-5. It is also structurally consistent with the statutory provisions governing insider trading enforcement that Congress enacted in 1984 and 1988. As discussed in Part III of this brief, Congress' decision in Section 20A of the Exchange Act to allow all contemporaneous marketplace traders to recover damages from a violator — without regard to whether they stood in any pre-existing fiduciary relationship — constituted legislative recognition of a duty running from the trader to marketplace victims.[10] If they were owed no disclosure duty, Congress would have had no reason to grant them the right to recover that it did.

II.

RULE 14e-3 IS A VALID AND ENFORCEABLE RULE.

The court of appeals erred when it held that Rule 14e-3 exceeded the SEC's rule-making authority. Three other courts of appeals have held that Rule 14e-3 is within the rule-making authority conferred on the SEC by the Exchange Act.[11] These decisions were grounded in the language and structure of the Exchange Act, and amici agree with their analysis.

Once the court below rejected the misappropriation theory under Section 10(b) and Rule 10b-5, it found that Rule 14e-3 had to be invalid as well. According to the court, "although

10. *See also* D. Langevoort, *supra*, at 6-33, 9-16; Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory: From Fairness to Efficiency and Back*, 52 Alb. L. Rev. 775 (1988).

11. *See SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *SEC v. Peters*, 978 F.2d 1162 (10th Cir. 1992); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (*en banc*), *cert. denied*, 503 U.S. 1004 (1992); *see also SEC v. Ferrero*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,120 (S.D. Ind. Dec. 2, 1993).

perhaps § 14(e) is the product of clearer legislative draftsmanship [than is Section 10(b)], the authority granted to the SEC under both provisions is fundamentally the same." 92 F.3d at 626. According to the court, if the Commission could not forbid trading on the basis of misappropriated information under Section 10(b), it followed that "the SEC exceeded its rulemaking authority by enacting Rule 14e-3 without including the requirement of a breach of a fiduciary duty." 92 F.3d at 624.

This reading of Section 14(e) renders its grant of rule-making authority unnecessary surplusage. Section 14(e) makes it "unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." Thus Section 14(e), unlike Section 10(b), contains a self-operative proscription of fraud, so that fraudulent conduct in connection with a tender offer violates Section 14(e) itself, and it does so entirely apart from any SEC rule. However, Section 14(e) also provides that the SEC shall "by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative." Inasmuch as fraudulent, deceptive and manipulative acts in connection with tender offers violate the statutory prohibition of Section 14(e) — and did so before the section was amended to give the Commission rule-making authority — the Commission's rule-making power under Section 14(e) extends to the regulation of conduct that is not necessarily fraudulent, deceptive, or manipulative, but that should be prescribed to prevent fraud, deception or manipulation.[12]

Tender offers present particularly acute problems of insider

12. *See United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992). This Court has recognized the breadth of the Commission's Section 14(e) rule-making power. *See Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 12 n.11 (1985); *see also Chiarella v. United States*, 445 U.S. 222, 234 (1980).

trading, given the sensitivity of the securities markets to information about tender offers and the possibility that those privy to information about such offers may abuse that information. Rule 14e-3 appropriately responds by forbidding securities trading by those in possession of material nonpublic information relating to a tender offer, if they know or have reason to know that the information comes from the tender offeror or target.[13] It is reasonably designed to prevent "fraudulent, deceptive, or manipulative" conduct.

III.

THE VALIDITY OF BOTH THE MISAPPROPRIATION THEORY UNDER RULE 10b-5 AND RULE 14e-3 HAS BEEN CODIFIED BY STATUTE.

The misappropriation theory under Rule 10b-5 and Rule 14e-3 are both well grounded in the language of Sections 10(b) and 14(e) of the Exchange Act. Even if their validity had initially been in question, however, Congress has legislatively codified the validity of the misappropriation theory and of Rule 14e-3 in enacted statutes and incorporated the misappropriation theory and Rule 14e-3 into the statutory regulatory scheme.

A. In legislation enacted in 1984 and 1988, Congress confirmed and codified that it is a violation of Section 10(b) and Rule 10b-5 for a person who has learned material nonpublic information in the course of a special relationship of trust and confidence to trade securities on the basis of that information in violation of fiduciary duties.

The court below rejected the misappropriation theory on the ground that insider trading cannot violate Section 10(b)

13. *See SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

unless the trader violates "a duty to parties to the securities transaction, or, at the most, to other market participants," 92 F.3d at 618, and it held Rule 14e-3 invalid on the theory that the any rule adopted under Section 14(e) must be limited to traders who breach a fiduciary duty. *Id.* at 624. However, Congress itself has made trading while in possession of material information illegal even when traders owe no fiduciary duty to those with whom they trade, and it has rejected the premise that liability attaches only when those in possession of material nonpublic information trade in breach of fiduciary duties.

In the Insider Trading Sanctions Act of 1984, Congress made it illegal for corporate insiders to trade options on corporate securities while in possession of material nonpublic information, although such insiders owe no duty to public options traders.[14] Section 20(d) of the Exchange Act, 15 U.S.C. § 78t(d) (1994), enacted in 1984, makes it unlawful to trade options while in possession of material nonpublic information whenever it would be unlawful to trade the underlying security. Publicly traded options are typically issued by securities dealers (and not by the corporations that issue the securities underlying such options), and corporations and their insiders do not owe fiduciary duties to those who own or trade options on corporate securities when those options are issued by others. Thus the statutory prohibition of option trading by those in possession of material nonpublic information is not based on the existence of the trader's duty to other market participants. Instead, liability is premised on the idea that, as this Court observed in *Dirks*, "fraud derives from the 'the inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.' " 463 U.S. at 654 (*quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)). The 1984 Act

14. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C.).

generalized the misappropriation theory, extending it beyond trading in corporate securities to trading in derivative securities based on the value of such securities. This extension makes sense only on the assumption the Congress already believed that any person trading on misappropriated material nonpublic information was violating Section 10(b) and Rule 10b-5, and Section 20(d) of the Exchange Act codified this belief as substantive law.

In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress confirmed that Section 10(b) prohibits trading while in possession of material nonpublic information even when traders owe no duty to those with whom they trade. Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (1994), added to the Exchange Act by the 1988 Act, permits contemporaneous public security traders to recover from those who illegally trade securities while in possession of material nonpublic information. The mechanism it uses for this remedy again indicates that the prohibition extends to trading by those who owe no duty to those with whom they trade.

Section 20A was enacted in response to *Moss v. Morgan Stanley, Inc.*, in which the Second Circuit, which had already found that trading on the basis of misappropriated information violates Section 10(b) and Rule 10b-5, held that contemporaneous traders had no private right of action against those who trade on the basis of such information.[15] 719 F.2d 5,

15. *See* House Comm. on Energy and Commerce, Insider Trading and S.E.C. Fraud Enforcement Act of 1988, H.R. Rep. No. 100-910 at 26-27 (1988) [hereinafter House Report], *reprinted in* 1988 U.S.C.C.A.N. 6043, 6063-64 ("In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. *See, e.g., Moss v. Morgan Stanley*. . . ."). Many

(Cont'd)

15-16 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). Section 20A codified an explicit private right of action for contemporaneous traders against those who violate the Exchange Act or its rules and regulations by trading securities while in possession of material nonpublic information. Section 20A expressly provides for a private right of action for contemporaneous traders, but it does not say when trading is illegal. Instead it relied upon and incorporated what at that time was a unanimous judicial recognition that trading on the basis of misappropriated information was already illegal.[16] The

(Cont'd)
commentators have recognized that Section 20A ratified the misappropriation theory. *See* D. Langevoort, *supra*, § 6.02, at 6-8 to 6-9 (1996); 8 L. Loss & J. Seligman, *supra*, at 3653 ("Presumably the adoption of § 20A resolves any lingering doubt as to whether there may be private rights of action to enforce the misappropriation theory."); Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 Bus. Law. 145, 166-67 (1989); *see also SEC v. Clark*, 915 F.2d 439, 451-53 (9th Cir. 1990) (citing the 1984 and 1988 Acts in support of its decision to enforce the misappropriation theory); *United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (*en banc*) (Winter, J., concurring in part and dissenting in part) (suggesting that the 1984 Act "seems premised" on the validity of the misappropriation theory), *cert. denied*, 503 U.S. 1004 (1992); 8 L. Loss & J. Seligman, *supra*, at 3638 ("[B]oth in 1984 and in 1988 the House Committee on Energy and Commerce indicated in legislative reports preceding unanimous enactment of insider trading legislation that the misappropriation theory should be enforceable under § 10(b) and Rule 10b-5.").

16. *See* House Report, *supra*, at 10, *reprinted in* 1988 U.S.C.C.A.N. at 6047 ("Within the court-developed parameters for insider trading, courts that have addressed the issue have also broadened the doctrine of insider trading to include trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants."); *id.* at 9-10, *reprinted in* 1988 U.S.C.C.A.N. at 6046-47 ("Under current case law, the SEC must establish that the person misusing the information breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information.").

mechanism that the 1988 Act used to create a private remedy for contemporaneous traders is predicated on the validity of the misappropriation theory.

B. Section 2 of the Insider Trading and Securities Fraud Enforcement Act of 1988 confirmed and codified that Rule 14e-3 is a valid and enforceable rule and that it is a violation of Section 10(b) and Rule 10b-5 to trade securities in the public securities markets based on material nonpublic information in breach of fiduciary duties.

In addition to establishing a private remedy against those who misappropriate material nonpublic information by trading in violation of their fiduciary duties, the Insider Trading and Securities Fraud Enforcement Act of 1988 explicitly established the validity of the misappropriation theory under Rule 10b-5 and of Rule 14e-3. Section 2 of the 1988 Act provides that

> The Congress finds that —
>
> (1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, non-public information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;
>
> (2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly; and
>
> (3) nonetheless, additional methods are appropriate to deter and prosecute violations of such rules and regulations.[17]

These enacted findings directly address the questions presented by this case: the validity of the misappropriation theory under Rule 10b-5 and of Rule 14e-3. They establish that the SEC acted within its statutory authority in adopting the rules, and that the SEC had enforced those rules vigorously, effectively, and fairly within the limits of accepted administrative and judicial construction.

Section 2 of the 1988 Act is not a mere hortatory condemnation of insider trading. Instead, it states that the SEC's rules and regulations governing trading while in possession of material nonpublic information are within the rulemaking power conferred upon the SEC by the Exchange Act. The scope and limits of the SEC's rulemaking power are set by Section 14(e), by Section 23(a) of the Exchange Act, 15 U.S.C. § 78w(a) (1994), which provides the Commission shall have "power to make such rules and regulations as may be necessary or appropriate to implement the provisions" of the Exchange Act, and by Section 10(b), which makes it unlawful to violate "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Thus the Commission's insider-trading regulations are within its statutory rulemaking power if they are necessary or appropriate. Section 2(1) of the 1988 Act establishes that they are, specifically providing that the rules "governing trading while in possession of material, non-public information are, as required by [the Exchange] Act, necessary and appropriate in the public interest and for the protection of

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17. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 2, 102 Stat. 4677, 4677 (1988) (appended to 15 U.S.C. § 78u-1 (1994)).

investors." When the 1988 Act was adopted, the misappropriation theory and Rule 14e-3 had been upheld by every court that had considered them. Section 2 of the 1988 Act codified these decisions, and establishes that the SEC has acted within its authority in enforcing the misappropriation theory and Rule 14e-3.

The "rules and regulations . . . governing trading while in possession of material, non-public information" to which Section 2 of the 1988 Act refers are clearly Rules 10b-5 (particularly the misappropriation theory under Rule 10b-5) and 14e-3. Rule 14e-3 by its terms makes it unlawful for a person to trade securities while "in possession of material information . . . he knows or has reason to know is non-public," and is thus within the ambit of Section 2 of the 1988 Act. Rule 10b-5 also governs trading while in possession of material nonpublic information; indeed it is the primary rule that governs such trading. Although Rule 10b-5 does not speak in terms of "trading while in possession of material non-public information," by 1988 this Court had construed it to regulate such trading in *Chiarella* and *Dirks*, and it was "well known that the basic prohibitions against insider trading arise from judicial interpretations of the general anti-fraud provisions of Section 10(b) of the Exchange Act and rule 10b-5."[18] By 1988, the SEC and various United States attorneys had used Rule 10b-5 to enforce the misappropriation theory vigorously, and indeed until 1995 every court to consider the theory upheld it. Moreover, the reference to "accepted administrative and judicial construction" in Section 2(2) of the 1988 Act and the Act's legislative history both establish that the

18. Kaswell, *supra*, at 153. This Court has recognized that similar language in Secton 20A, which was added by the 1988 Act, refers to Rule 10b-5 to the extent that it governs trading while in possession of material nonpublic information. *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-61 (1991).

purpose of the 1988 Act was to validate the misappropriation theory as well as Rule 14e-3.[19]

Of course, no court has held Rule 10b-5 invalid, but the Eighth Circuit did hold that the SEC is without power under Section 10(b) to regulate trading on the basis of misappropriated information. However, the Commission does have power to regulate such trading because such regulation is, in the words of the statute, "necessary and appropriate." To negate any possibility that the misappropriation theory was beyond the SEC's regulatory power, Section 2 of the 1988 Act states that the rule under which the theory was enforced was within the SEC's rulemaking power and that the SEC's enforcement of that rule was appropriate. Indeed, the statutory standard that Section 2(1) of the 1988 Act says was satisfied — "necessary and appropriate in the public interest and for the protection of investors" — is the rule-making standard of Section 10(b).

In sum, by enacted statutes, Congress in 1984 made it unlawful and privately actionable for those in possession of material nonpublic information to trade options even when they owe no duty to those with whom they trade; in 1988 incorporated the misappropriation theory into the Exchange Act; and in 1988 declared that the SEC rules governing trading while in possession of material nonpublic information are authorized by the Exchange Act. Accordingly, the Eighth Circuit erred in

19. *See* House Report, *supra*, at 35, *reprinted in* 1988 U.S.C.C.A.N. at 6072 ("These findings are intended as an expression of congressional support for these regulations."); *id.* at 10-11, *reprinted in* 1988 U.S.C.C.A.N. at 6047-48; *see also* 134 Cong. Rec. E3078 (Sept. 23, 1988) (statement of Rep. Markey, principal author of the 1988 Act) ("One area in which there is strong congressional consensus is the validity of the 'misappropriation' theory of insider trading."). Shortly after the 1988 Act was enacted, the minority (Republican) counsel to the House Committee on Energy and Commerce wrote that the findings were enacted to assist the SEC in its efforts to bring insider trading cases. Kaswell, *supra*, at 157.

holding that the SEC had exceeded its authority in enforcing the misappropriation theory and adopting Rule 14e-3.

C. The 1988 Act's enacted declaration of long-standing congressional intent is entitled to substantial weight, even with respect to trades occurring before its enactment.

In his brief in opposition to the government's petition for writ of certiorari, respondent acknowledged that the 1988 Act "created a private cause of action for misappropriation."[20] This legislative action, as well as the 1988 Act's express declaration of the validity of the misappropriation theory and Rule 14e-3, indicate that the Eighth Circuit's decision should be reversed. Even though the respondent traded before the 1988 Act was enacted, the 1988 Act codified the well-established validity of the misappropriation theory and Rule 14e-3, and, as discussed below, the findings contained in Section 2 of the 1988 Act are entitled to significant weight in determining what Sections 10(b) and 14(e) meant even before it was enacted.[21]

Given that respondent's conduct predated the 1988 Act and that he apparently agrees that trading on the basis of misappropriated information has violated Section 10(b) since that Act was enacted, it would presumably be inappropriate in this case to hold that the misappropriation theory is not valid now, even if it was invalid before 1988. However, respondent's brief in opposition to the government's petition can also be read to suggest that Congress acted in 1988 because the misappropriation theory was not settled law, and that the 1988

20. *See* Respondent's Brief in Opposition to Petition for Writ of Certiorari at 20 (Jan. 17, 1997).

21. *See United States v. Winstar Corp.*, 116 S. Ct. 2432, 2463 (1996) ("Subsequent legislation declaring the intent of an earlier statute is entitled to significant weight.") (*quoting NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 (1974)).

Act represents at most acquiescence in the misappropriation theory and not a binding statement of congressional intent.[22] These suggestions are incorrect. The 1988 Act codified the already established law that the misappropriation theory under Rule 10b-5 was valid and enforceable.

Amici are aware that congressional silence does not constitute binding acquiescence in erroneous lower court decisions.[23] However, the 1988 Act is precisely the opposite of congressional silence, and Section 2 of the Act codifies the validity of the misappropriation theory and Rule 14e-3 not by acquiescence but by express enactment. Similarly, the amendments to the Exchange Act enacted by the 1984 and 1988 Acts were premised on the continued validity of the misappropriation theory. Every court that had reviewed the misappropriation theory and Rule 14e-3 before 1988 had held them valid, and the structure of the 1988 amendments to the Exchange Act shows that Congress depended upon that precedent.

Amici also disagree with the proposition that because Congress codified the misappropriation theory as law in 1988, respondent cannot be punished for violating Section 10(b) before the 1988 Act was enacted. The misappropriation theory was well established by 1988, and indeed the 1988 Act was apparently structured as it was precisely because the validity of that theory and of Rule 14e-3 were established. To be sure, if there was ever any doubt about the status of the misappropriation theory and Rule 14e-3, the 1988 Act establishes their validity for conduct occurring after it was enacted. However, aside from

22. *See* Respondent's Brief in Opposition to Petition for Writ of Certiorari at 21-22, 26-27.

23. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 185-88 (1994).

the question of whether any new law the 1988 Act created would be retroactive, the 1988 Act's explicit, enacted declaration that the SEC acted within its power in adopting and enforcing its rules is in itself important evidence that the misappropriation theory and Rule 14e-3 were valid and enforceable before the 1988 Act was adopted.

As this Court recently noted, "[s]ubsequent legislation declaring the intent of an earlier statute is entitled to significant weight."[24] This Court has long recognized this principle.[25] In

24. *United States v. Winstar Corp.*, 116 S. Ct. 2432, 2463 (1996) (quoting *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 275 (1974)); *see also id.* at 2461-63 (citing 1987 statute's recognition of administrators' power to bargain away Congress's power to change the law to support finding that they had that power before the statute was enacted); *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-82 (1969) ("Subsequent legislation declaring the intent of an earlier statute is entitled to great weight in statutory construction. And here this principle is given special force by the equally venerable principle that the construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong, especially when Congress has refused to alter the administrative construction. Here, the Congress has not just kept its silence by refusing to overturn the administrative construction, but has ratified it with positive legislation.") (citations omitted).

25. *See, e.g., Alexander v. Mayor & Commonalty of Alexandria*, 9 U.S. (5 Cranch) 1, 7-8 (1809) ("[A]cts *in pari materia* are to be construed together as forming one act. If in a subsequent clause of the same act provisions are introduced, which show the sense in which the legislature employed doubtful phrases previously used, that sense is to be adopted in construing those phrases. Consequently, if a subsequent act on the same subject affords complete demonstration of the legislative sense of its own language, the rule which has been stated, requiring that the subsequent should be incorporated into the foregoing act, is a direction to courts in expounding the provisions of the law. "); *see also Postmaster v. Early*, 25 U.S. 136, 148 (1827) (The words of the statute at issue "perhaps, manifest the opinion of the legislature, that the jurisdiction was in the Circuit Courts; but ought, we think, to be construed to give it, if it did not previously exist.").

addition to firmly establishing the validity of the misappropriation theory and Rule 14e-3, the 1984 and 1988 Acts constitute legislative statements that Congress understood them to be valid already, and these statements are entitled to respect. Section 2 of the 1988 Act, in particular, is a declaration that the misappropriation theory and Rule 14e-3 had always been within the SEC's power. Congress' confidence was well placed in light of the unanimity of contemporary precedent to the same effect, and its enacted statement is due special credence in light of this Court's repeated insistence that it is up to Congress to declare what is forbidden by the securities laws.[26]

CONCLUSION

The decision of the Eighth Circuit should be reversed.

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26. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 173 (1994); *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983); *Chiarella v. United States*, 445 U.S. 222, 234 (1980); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976). In any event, if this Court determines that respondent's convictions for violating the securities laws should not be upheld, it should note that the misappropriation theory and Rule 14e-3 are now valid and enforceable.

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